



**Investment Office**

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**AGENDA ITEM 7f**

**TO: MEMBERS OF THE INVESTMENT COMMITTEE**

- I. SUBJECT:** Affiliate Funds – Internationally Indexed Portfolio
- II. PROGRAM:** Global Equity
- III. RECOMMENDATION:** Approval of Affiliate Funds Participation in PERF International Equity Index Portfolio

**IV. ANALYSIS:**

The Affiliate funds [(Legislators' Retirement Fund (LRF), Judges' Retirement II Fund (JRF II), Long-Term Care Trust Fund (LTCF) and Supplemental Contribution Plan (SCP)] currently obtain international equity exposure through investment in State Street Global Advisors (SSgA) commingled index funds. These investments have an approximate value of \$425 million and are benchmarked to the MSCI EAFE (Europe, Australasia, Far East) index which represents non North American developed markets. These funds have been managed by SSgA under the agreement by which the organization managed the CalPERS FTSE international index portfolio. SSgA has not charged the funds for this management.

In conjunction with internalizing the management of the CalPERS international index portfolio, staff proposes to utilize Multiple Class accounting to pool the affiliate funds' international equity exposure along with the PERF's portfolio. With Multiple Class accounting, different funds can contribute to a pool of assets while maintaining unique historical records and proportional entitlement to portfolio income, gains and losses, and certain expenses.

Multiple Class accounting has been approved by the Investment Committee in the past for this purpose. The most recent example was in April 2005 when the Investment Committee approved Affiliate Fund participation in PERF fixed income portfolios.

The most significant impacts of this change would be:

- Change the affiliates' benchmark from the MSCI EAFE index to the FTSE All World Developed ex U.S.
- Addition of Canadian exposure
- Exclusion of tobacco
- Extension of capitalization coverage to 90% from 85%

Staff views the MSCI and FTSE benchmarks as providing virtually equivalent investment exposures although the inclusion of Canada and the deeper capitalization coverage may provide a small marginal benefit. Tobacco represents just over 1% of the capitalization of either benchmark. The expected tracking variance between the two benchmarks is approximately 45 basis points and historic annualized performance of the two benchmarks has been very close:

	<u>1 Yr</u>	<u>3 Yr</u>	<u>5 Yr</u>
FTSE All World Developed ex U.S.	24.30%	23.74%	11.46%
MSCI EAFE	24.51%	23.85%	11.07%

A benefit to the Affiliate Funds of pooling the assets with the PERF would be to have these assets managed for no management fee as staff can absorb this activity with no further resources. Changing the Affiliates' existing exposure to the CalPERS FTSE benchmark will cause about 10% one-time turnover and cost approximately 5 basis points or \$212,000.

### **Alternatives**

There are alternative solutions available should the Investment Committee decline this proposal. The first alternative would be to submit the management of these funds to the RFP process. Staff believes the management fees would be in the range of 4 to 5 basis points or about \$190,000 annually. A second possibility would be for internal staff to manage a separate MSCI EAFE portfolio for the Affiliate Funds. This activity would likely result in a data expense to obtain benchmark constituent information from MSCI. An estimate of this cost would be \$25,000 - \$50,000 annually. Selection of this alternative would also serve to reduce staff's capacity to manage other strategies.

**V. STRATEGIC PLAN:**

This agenda item is consistent with CalPERS Strategic Plan, Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions; and Goal IX: Achieve long-term, sustainable, risk adjusted returns.

**VI. RESULTS/COSTS:**

There is no incremental cost to CalPERS for this proposal. The Affiliate Funds would sustain a one-time turnover expense of about 5 basis points or \$212,000.

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